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In the Supreme Court of the United States

OCTOBER TERM, 1995

AMERICAN MUTUAL LIFE INSURANCE COMPANY
AND SUBSIDIARIES,
Petitioner,

v.

UNITED STATES OF AMERICA

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

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REPLY BRIEF FOR PETITIONER

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1. In this, perhaps the largest federal income tax case ever brought before the Court, the government's brief hardly addresses the only issue that is relevant at this stage—whether this case warrants review. Focusing almost entirely on the merits, the government fails to refute any of Petitioner's arguments regarding the importance of the question presented and the urgent need for a definitive resolution now rather than later.

- Nowhere does the government deny that the legal issue at stake involves $5 billion dollars in industry-wide taxes.
- Nowhere does the government refute that this is an issue that affects the tax liability of every mutual life insurance company doing business in the United States.
- Nowhere does the government challenge the fact that unless this Court resolves the issue, there will be a multiplicity of litigation filed in virtually

every federal circuit. In fact, the government seems to endorse the desirability of this state of affairs. *See* Gov't Br. 17-18.

- Nowhere does the government deny that the court of appeals' decision places mutual life insurance companies at a competitive disadvantage to the more than 2,000 stock life insurance companies.[1]
- Nowhere does the government take issue with the fact that more than 100 million mutual policyholders and beneficiaries will be affected by the ultimate resolution of this question.

The government could hardly challenge any of the above because it is already on record in agreeing with Petitioner that this case is of utmost importance. A little over a year ago, after the government had lost in the district court, Department of Justice attorneys were asserting that "this case presents a complex and important issue of first impression . . . . [that] has industry-wide significance . . . ." [Government's] Unopposed Motion for Extension of Time for Filing Appellant's Brief, No. 94-1440 at ¶ 2 (8th Cir.) (filed on March 31, 1994); *see also* Brief for the Appellant, at i, No. 94-1440 (8th Cir.) (filed on May 2, 1994) (requesting oral argument "in view of the importance of the issue presented, which arises with respect to *all* mutual companies") (emphasis in original).

2. Apart from the government's elaborate effort to defend the court of appeals' decision on the merits, the only ground that it offers for opposing review is that there is no circuit conflict. But this is far from a neutral principle that consistently guides the government's liti-

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[1] The import of this case was recently underscored by a letter from the Iowa Commissioner of Insurance to the Solicitor General, urging the government to acquiesce in the petition so that this issue could be resolved sooner rather than later. *See* Supp. App. 1a. As that letter demonstrates, unless this Court resolves this issue, the uncertainty, along with mutual companies' "limited ability to access the capital markets," will have "a significant impact" on the future of the mutual life insurance industry. *Id.* 2a.

gating position. As demonstrated by petitions filed by the government as recently as this Term, the real principle guiding the government is not whether there is a circuit conflict, but whether the government has won or lost below. *See* Petition for Certiorari, *United States v. Xerox Corp.*, No. 94-2005 (filed June 7, 1995); Petition for Certiorari, *United States v. County of San Diego*, No. 95-128 (filed July 21, 1995) (involving state *ad valorem* taxes); *see also* Reply Brief for the United States, *United States v. American College of Physicians*, No. 84-1737, at 10, 11 (filed June 21, 1985); [Government's] Petition for Certiorari, *Commissioner v. Lincoln Sav. & Loan Ass'n*, No. 544 OT 1970 (filed Aug. 14, 1970); [Government's] Petition for Certiorari, *United States v. Atlas Life Ins. Co.*, No. 489 OT 1964 (filed Sept. 11, 1964).[2] In all of these tax cases, the government lost in the court of appeals and sought review in this Court, even in the absence of a conflict. Likewise here, if the court of appeals had affirmed the district court's decision in favor of the taxpayer, the government would have been urging the Court to grant review, using the same arguments as Petitioner has made about the importance of the question presented, notwithstanding the absence of a conflict. The government is simply incorrect when it suggests that it will seek review in a tax case in the absence of a conflict only when the adverse decision has been rendered by the Federal Circuit. *Atlas* resulted from a Tenth Circuit decision; both *San Diego County* and *Lincoln Savings* arose from the Ninth Circuit.

3. The government's misunderstanding of the statutory provision at issue runs so deep that, even in its statement of the question presented, the government makes no fewer than three critical errors. First, the government refers to the relevant year as "a year in which the average mutual company earnings rate exceeds the average stock company rate." Gov't Br. (I). Section 809, however, *never* compares a one-year average of mutual company

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[2] Relevant excerpts of these petitions are quoted in the Brief *Amici Curiae* at 6 n.8, 9 n.13, and 10 n.15.

earnings rates with the same one-year average of stock company rates. As stated clearly in the statute, the comparison is between a one-year mutual company average and a prior three-year stock company average.[3] Second, the government asks whether the mutual company is allowed to "take a policyholder dividends deduction." *Id.* The Section 809(f)(2) deduction at issue, however, is explicitly referred to as a "life insurance deduction," which, as Sections 804 and 805 demonstrate, includes many more kinds of deductions than just a policyholder dividend deduction. Finally, the government explicitly ties what it terms the "policyholder dividend deduction" to the "actual amount of [a mutual life insurance company's] dividends," a link that is simply nonexistent in the statutory language. The government employs this sloppy and misleading terminology because it perceives that it is to its advantage to mix Section 808 with Section 809 and conflate the policyholder dividend deduction with the life insurance deduction. The court of appeals permitted the government to benefit from this approach, but this Court should not.

4. The government's "factual" explanation of Section 809 is a fanciful mixture of quotes from the statute, unstated assumptions, and imaginative statements of the statute's purpose made up from whole cloth. Perhaps most egregious are the government's claims that Section 809(f)(2) "compensates the company for its excessive reduction of its policyholder dividend deduction in the original taxable year," and that Section 809(f)(1) exists "to compensate the government for the excessive deduction taken in the original taxable year." Gov't Br. 5. The government's assertion that Section 809(f) was drafted to "compensate" the government (or the taxpayer) for an "excessive" deduction (or reduction) taken in the previous year is insupportable. Pursuant to Section

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[3] As the Brief *Amici Curiae* correctly points out, for 1986 (the year at issue), the average mutual company earnings rate was *not* greater than the average stock company earnings rate. *Amici* Br. 17.

809(a), mutual life insurance companies pay the correct amount of taxes due in the first year. If they are allowed to take a dividend deduction, they do so. Neither the government nor the taxpayers need to be "compensated" in the next year, for there was nothing "excessive" paid or deducted in the first year. The fundamental flaw in the government's argument is its unstated underlying assumption, namely, that the operation of Section 809 must somehow be tied to the amount of dividends actually paid by a mutual company in a given year. That assumption is false. There simply is no statutory language that connects the amount of income imputed or the amount of deductions allowed to the amount of dividends paid in any single year. Indeed, it is undisputed that Section 809(f)(1) specifically commands the imputation of income even if no dividends at all have been paid, and that the amount of such imputed income does not depend in any way on the amount of policyholder dividends accrued or paid in any given year.

Moreover, the government's assumption cannot be reconciled with the mechanism chosen by Congress, which is a multi-year formula that compares a one-year mutual average to a *prior three-year* stock average. Although the government acknowledges in its statement of the case that the statute mandates this apples-and-oranges comparison, the government then seeks to gloss over the significance of this fact for the statute's proper operation. *Compare* Gov't Br. 3-5 *with id.* 15 n.9. It is precisely *because* Congress chose to employ a multi-year formula that the statutory construction urged by the government is so flawed. By building in the requirement that earnings rates from different stages of the economic cycle be compared with each other, Congress virtually ensured that the recomputed differential earnings rate would be negative for some years (even if, for any given year, the stock earnings rate was higher than the mutual earnings rate). Congress having created such a multi-year comparison and the resulting negative differentials, it is peculiar indeed to argue, as the government does, that Congress

simultaneously intended to ignore such negatives, especially when Congress did not say anything to indicate such an intent.

As demonstrated in the petition, *see* Pet. 6-9, the multi-year formula chosen by Congress, if it is to function in a statistically valid way, must be interpreted to include the years in which negative results are obtained. Significantly, the government does not dispute that the statistical analysis provided by Petitioner is correct.[4] Instead, it admits that its reading of Section 809 essentially mandates that the overall tax liability of a mutual life insurance company depends on whether industry earnings rates fluctuate or remain in steady-state. If the rates are in steady-state, then no negatives arise and the mutual industry pays a certain percentage. If, however, the rates fluctuate, as they inevitably do, the mutual life insurance industry must pay a *higher* rate. The government offers no explanation why Congress would have wanted the tax liability for an entire industry to hinge upon such a whimsical factor.[5] The government completely misses the mark in stating that Petitioner is urging a certain "policy" in its interpretation of the Section. It is not a policy that Petitioner urges, it is merely sensible statutory interpretation, because it makes absolutely no sense to interpret the statute the way the government does.

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[4] The government's only comment on the statistical evidence is to ridicule Petitioner's "concept of statistical purity." Gov't Br. 15 n.9. Yet, this is not an abstract concept, and the government's comment tries to denigrate without denying that the results are factually accurate. One can certainly accept the proposition that Congress chose the multi-year formula to smooth out tax liabilities for mutual companies without at the same time accepting the further and very different proposition that Congress intended to ignore the negatives produced by its formula.

[5] The government attempts to justify the result as a simple mistake that was contrary to Congress's expectations. *See* Gov't. Br. 8. Yet Congress had no expectations about what the result of its multi-year formula would be. It only expected that on a year-to-year comparison, the average stock earnings rate would be greater than the average mutual earnings rate. As demonstrated in the Brief *Amici Curiae*, this expectation has generally held true.

5. The "common-sense understanding of Congress's intent," Gov't Br. 12, urged by the government has nothing to do with common sense and everything to do with rhetoric. Petitioner does not disagree that Section 809 was enacted to impose increased taxes on the mutual life insurance industry. The only question is how draconian that increase was intended to be. Despite the government's rhetoric that Petitioner's interpretation, if accepted, would create a "windfall" for mutual companies, nothing could be further from the truth. Even under Petitioner's interpretation, Section 809 functions to reduce mutual companies' deductions for policyholder dividends and thus to increase their taxes. If Section 809, as interpreted by Petitioner, is the government's idea of a "windfall," it is one that the industry gladly would forgo.

6. Contrary to the government's assertion, the court of appeals did not rule in the government's favor on two independent grounds. Although the Eighth Circuit did suggest that Section 808 should be read to limit Section 809, it did not state that its ruling could be supported by this reasoning even if the court were to have rejected the government's reading of Section 809 itself. *See* Pet. App. 5a-6a. Moreover, the government neglects to inform this Court that Sections 804 and 805 of the statute do not support the government's narrow reading of the term "life insurance deduction." According to the government that term refers to "both the policyholder dividends deduction . . . and the reserve deduction." Gov't Br. 14. Yet Sections 804 and 805 define "life insurance deduction" to include no fewer than eight enumerated deductions, including a catch-all "other deductions" category. *See* 26 U.S.C. §§ 804, 805(a)(8). Although policyholder dividend deductions may be a species of life insurance deductions, it can in no way be said that the "life insurance deduction" in Section 809(f)(2) refers solely to a policyholder dividend deduction or a reserve deduction.

In any event, the government fails to mention that the district court rejected out-of-hand the argument that Section 808(c) implicitly limits Section 809, when that theory was presented in the absence of the "winning theory" (first raised in the court of appeals) that under Section 809 the recomputed differential earnings rate can never be negative. As the district court held, there simply is no statutory language or legislative history that supports the government's attempted reliance on Section 808(c). Pet. App. 16a. Instead, although the Section 808(c) policyholder dividend deduction is explicitly limited by Section 809, the life insurance deduction authorized by Section 809(f)(2) is not limited by Section 808. And when Congress decided to enact Section 809(f)(2) without tying it to the amount of policyholder dividends paid in a given year, it must be assumed that Congress knew what it was doing. In this case, the district court gave the proper deference to Congress, stating that "[i]t is for Congress, not the courts, to rewrite statutes." Pet. App. 16a.

Furthermore, an important part of the government's argument that Section 808 limits Section 809(f)(2) is that otherwise Section 808 would be rendered a nullity. This simply is not true. In each year, Section 808(c) does exactly what it was drafted to do—it limits the policyholder dividends deduction taken in that year to the amount of policyholder dividends actually paid in that year. It is somewhat disingenuous for the government to state that a provision that limits the amount of policyholder dividends that a company can take in a single year is a nullity. Section 808(c) functions in the same way it was always intended to function, even under Petitioner's interpretation of Section 809(f)(2).

7. Although the government suggests that mere reference to a dictionary eliminates any question about the meaning of the statute, that notion is difficult to accept, given that the government itself has come up with diametrically opposed definitions of the language at issue. In this case the government has found it necessary to

define and then *redefine* the term "excess." Originally, the government (including the IRS and the government's hired expert and attorney in the district court) agreed with Petitioner that "excess" as used in Section 809(c) means "difference" and that therefore Section 809(c)'s formula produces negative rates in certain circumstances. For the government to argue now that there is only one true meaning of the word "excess" and that that meaning is readily apparent ignores the history of the government's own interpretation of this statute.

Petitioner does not quarrel, as the government suggests, with the government's power to correct an error in interpretation. Rather, the issue is whether there *was* any error in the first place. Obviously, the government was either wrong in its original interpretation or it is wrong now. Petitioner respectfully suggests that the government's initial neutral construction, made before any tax implications were known and before the government's approach to the legal issue presented here was skewed by the desire to enhance revenues, is more reliable. This Court's decisions involving the deference that should be given to after-the-fact agency interpretations of statutes suggests that it agrees with Petitioner's approach. *See Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944); *see also* Brief *Amici Curiae* 20 (citing cases). Notwithstanding this Court's precedent, the court of appeals stated that the agency interpretation in this case was "entitled to great deference." Pet. App. 8a.

As explained in the Petition, *see* Pet. 27, Congress knew exactly what it was doing by using the term "excess" in both Sections 809(a) and 809(f) in situations that refer solely to positive numbers. Both those sections provide specific instructions on what is to be done when one number is larger than the other. In both cases, Congress directed that the effects of Section 809 were to be applied in different ways based on whether one number was larger than the other. In contrast, Section 809(c) provides that only one calculation is to be performed.

By implication, it does not matter whether one number is larger than the other; the nature of the computation will be the same for all potential values of the variables involved. Hence, the synonym for "excess" in Section 809(c) is the noun "difference," not the government's verb "surpass."

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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September 29, 1995

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APPENDIX

SUPPLEMENTAL APPENDIX

STATE OF IOWA

TERRY E. BRANSTAD, Governor

Therese M. Vaughan, Commissioner

INSURANCE DIVISION
Iowa Department of Commerce

September 15, 1995

Hon. Drew S. Days, III
Solicitor General United States
Department of Justice
Tenth & Constitution Avenue N.W.
Washington, D.C. 20530

Dear Mr. Days:

As Commissioner of Insurance of the State of Iowa, I regulate the activities of a number of mutual insurance companies. As such I have a significant interest in the rights of their policyholders, the financial condition of individual companies, and the industry as a whole. The life insurance industry is an integral component of the economy and a vital resource for both the United States and its individual citizens. Life insurance constitutes a significant portion of the personal savings and investments for nearly two-thirds of all Americans. Additionally, life insurance companies provide the third largest domestic source of funds for the U.S. financial markets.

On July 19, 1995 American Mutual Life Insurance company filed a Petition For a Writ of Certiorari with the United States Supreme Court in the case of *American Mutual Life Insurance Company and Subsidiaries v. United States of America.* This case involves the proper interpretation and application of Section 809 of the Internal Revenue Code and is of great significance to the life insurance industry. At the present time, despite the opinion of the Eighth Circuit in this case, mutual life insurers are in a state of uncertainty with respect to their

future tax liabilities. $5 billion is at stake and the availability of the $5 billion currently at issue. While the Division of Insurance is not taking any position on the merits of this case, I believe, for the reasons set forth herein, that the issues involved in this case must be determined with certainty as soon as possible.

The life insurance industry is at a crucial turning point as a result of increasing competitive pressures from banks, mutual funds, and other financial institutions which have placed severe pressure on their profit margins. During this same period, the financial resources of these companies have undergone increased scrutiny from government regulators, rating agencies, and the public. The need for a strong capital and surplus position has never been more important for life insurance companies than it is now.

This pressure to respond to competition while simultaneously enhancing capital and surplus has created a significant dilemma for life insurers and especially mutual life insurers because of their limited ability to access the capital markets. It has caused many mutual insurers to reassess the fundamentals of their business and has contributed to significant consolidation in the industry as is demonstrated by the recently proposed mergers of Metropolitan Life and New England Life, and Massachusetts Mutual and Connecticut Mutual Life. Companies throughout the industry are currently weighing alternatives with respect to future competitive strategies, the continuation of their current legal structures for conducting business, and in some cases the continuance of their independent existence.

A key to any company's decision making and strategic planning is an evaluation of its capital and surplus position. Until the issues raised in the *American Mutual* case are finally resolved, the mutual insurance industry will remain uncertain about the treatment of $5 billion in revenues. These decisions will have a significant impact upon the future not only of those companies but of the

entire industry. To require companies to make these decisions without certainty about their current financial resources or their future tax liabilities is not only unfair to the companies, but also constitutes an injustice to their policyholders.

As the Commissioner of Insurance for Iowa, I have the responsibility for safeguarding the interest of the policyholders and the public in overseeing the operations and financial integrity of Iowa's insurance companies. Without taking any position on the merits of the *American Mutual* case, I am requesting that the government acquies[c]e in American Mutual's pending Petition and urge the Supreme Court of the United States to grant review of this case. Only in this way can mutual life insurance companies make fully informed decisions affecting their policyholders and their strategic direction.

Sincerely,

/s/ Terri M. Vaughan
TERRI M. VAUGHAN, Ph.D.
Commissioner of Insurance